Supreme Court, U.S.
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No. _____

IN THE

Supreme Court of the United States

October Term, 1996

HAROLD CHAKALES AND LINDA CAROL CHAKALES
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ Of Certiorari
To The United States Court of Appeals
for the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a "sham transaction" for purposes of imposing the 26 U.S.C. § 6621(c) penalty interest rate for "tax motivated transactions" includes any transaction that does not have economic substance regardless of the taxpayer's motives in entering into the transaction or whether the absence of a business purpose or profit motive is a second necessary element to constitute a "sham transaction."

2. Whether a reasonably prudent person is required not only to make full disclosure to his tax advisor, but also ensure that the tax advisor (*e.g.*, CPA or tax attorney) has specialized expertise in the transactions and tax law related to those transactions, and further verifies that the tax advisor conducts an independent background investigation of the parties and facts relayed to the transactions before reliance on the advisor may constitute a defense against the imposition of the negligence penalty under 26 U.S.C. § 6653(a).

TABLE OF CONTENTS

QUESTIONS PRESENTED i
TABLE OF CONTENTS ii
TABLE OF AUTHORITIES iii
OPINIONS BELOW 1
JURISDICTION 2
STATUTORY PROVISIONS INVOLVED 2
STATEMENT OF THE CASE 2
1. Statement of the Facts. 3
a. Facts re Dr. Chakales 3
b. Facts re First Western Government Securities and Related Test Cases. 5
2. Chakales Proceedings in the Tax Court and on Appeal. 6
REASONS FOR GRANTING THE PETITION 7
1. Reasons Regarding the Question on Sham. 7
a. A Brief History of § 6621(c). 7
b. A Conflict Between the Circuits Exists as to The Definition of "Sham." 7
c. The Federal Circuit Courts of Appeal, United States Court of Federal Claims, Tax Court And Other Lower Courts Apply an Array Of Various and Conflicting Tests And Definitions to the Determination of "Sham." 10
(1) Cases Adopting Two-prong Approach: 11
(2) Cases Adopting a No-fault "Sham" Definition. 13
d. A Split Exists Between the Federal Circuit Courts of Appeal Regarding the Test To Be Applied in Determining a Taxpayer's "Profit Motive," as That Term Is Used For Purposes of § 6621(c). 14
2. Reasons Regarding the Negligence Question. 16
a. A Major Split Exists Between the Courts Of Appeals on the Degree to Which a Taxpayer must "Second Guess" His Professional Tax Advisors. 16
CONCLUSION 25
APPENDIX ..... App. 1

TABLE OF AUTHORITIES

Cases

Anderson v. Commissioner, 62 F.3d 1266 (10th Cir. 1995) 24
Balboa Energy Fund 1981 v. Commissioner, ___ F.3d ___, [96-1 U.S.T.C. ¶50,117] (9th Cir. 1996) 24
Betson v. Commissioner, 802 F.2d 365 (9th Cir. 1986) 24
Braddock Land Co. v. Commissioner, 76 T.C. 324 (1980) 14
Chakales v. Commissioner, 68 T.C.M. (CCH) 479, *aff'd.* 79 F.3d 726 (8th Cir. 1996) ("*Chakales I*") 6,8,14,16,19,20
Chakales v. Commissioner, 79 F.3d 726 (5th Cir. 1996) ("*Chakales II*") 6,13,14,17,21,22,24
Chamberlain v. Commissioner, 67 T.C.M. (CCH) 2992, 66 F.3d 729 (5th Cir. 1995) ("*Chamberlain I*") 9,10,14,17,18,20,21
Chamberlain v. Commissioner, 66 F.3d 729 (5th Cir. 1995) ("*Chamberlain II*") 12,15,17,19,21,24
David v. Commissioner, 43 F.2d 788 (2d Cir. 1995) 3, 5, 6, 8-10, 13,, 20, 21
Drobny v. United States, ___ F.2d ___ (Fed. Cir. 1996) 12
Durrett v. Commissioner, 67 T.C.M. (CCH) 2735, *aff'd in part* 71 F.3d 515, 518 (5th Cir. 1996) ("*Durrett I*") 9,10,14
Durrett v. Commissioner, 71 F.3d 515, 518 (5th Cir. 1996) ("*Durrett II*") 12,17,21
Ewing v. Commissioner, 20 T.C. 216, 233 (1953), *aff'd.* 213 F.2d 438 (2d Cir. 1954) 15
Forseth v. Comm'r., T.C. Memo 1985-279 (June 11, 1985) 8,13
Fox v. Commissioner, 82 T.C. 1001 (1984) 15,16
Frank Lyon Co. v. United States, 435 U.S. 561 (1978) 11

Freytag v. Commissioner, 89 T.C. 849 (1987),
aff'd. as to four of nine Petitioners,
904 F.2d 1011 (5th Cir. 1990),
aff'd. 501 U.S. 868 (1991) (*"Freytag I"*). . . . 3,5,6,8,9,10,13,17,19
Freytag v. Commissioner, 904 F.2d 1011 (5th Cir. 1990),
aff'd. 501 U.S. 868 (1991).(*"Freytag II"*). 6,10,13,21
Gill v. Commissioner, F.3d ,
[96-1 U.S.T.C. ¶50,138] (6th Cir. 1996) 24
Gilman v. Commissioner, 933 F.2d 143
(2nd Cir. 1991), *cert. denied* (1992) 11
Gould v. Commissioner, 67 T.C.M. 3013 (1994) 9
Gregory v. Commissioner, 293 U.S. 465 (1935) 10, 16
Horn v. Commissioner, 968 F.2d 1229 (DC Cir. 1992) 12
Hunt v. Commissioner, 938 F.2d 466 (4th Cir. 1991) 11
Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir.1989) 14
Knetsch v. United States, 364 U.S. 361 (1960) 7
Kozlowski v. Commissioner, 66 T.C.M. 754 (1993) 9
Lax v. Commissioner, 95-2 U.S.T.C. ¶50,639 (3rd Cir. 1995) 24
Leonhart v. Commissioner, 414 F.2d 749, 750 (4th Cir. 1969) . . . 22
Lerman v. Commissioner, 939 F.2d 44 (3rd Cir. 1991) 13
Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991) 11, 12
Mahoney v. Commissioner, 808 F.2d 1219 (6th Cir. 1987) 13
McMurray v. Commissioner, ___ F.2d ___,
[93-1 USTC ¶50,107] (1st Cir. 1993) 24
Murphy v. Commissioner, ___ F.2d ___,
[93-1 USTC ¶50,054] (9th Cir. 1993) 24
Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993) 24
Rice's Toyota World, Inc. v. Commissioner,
752 F.2d 89 (4th Cir. 1985) 14, 16
Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989) 11
Schrum v. Commissioner, 33 F.3d 426 (4th Cir. 1994) 24
Skeen v. Commissioner, 864 F.2d 93 (9th Cir. 1989) 12
Transpac Drilling Venture, 1983-2 v. United States,
32 Cl.Ct. 810, *aff'd* ___ F.3d ___ (Fed. Cir. 1996) 13
United States v. Boyle, 469 U.S. 41 (1985) 21, 22
United States v. Wexler, 31 F3d 117 (3rd Cir. 1994) 13

Statutory Provisions

26 U.S.C. § 6213(a) 6
26 U.S.C. § 6214 6
26 U.S.C. § 6621(c) 2, 7, 8
26 U.S.C. § 6621(d) ..... i, 2, 6
26 U.S.C. § 6653(a) 2, 6, 23
26 U.S.C. § 6653(a)(1) 2, 6, 23
26 U.S.C. § 6653(a)(2) 6, 23
26 U.S.C. § 6659 6
26 U.S.C. § 7442 ..... 6, 16
26 U.S.C. § 7482(a)(1) 2
26 U.S.C. § 7482(b)(1)(A) 2
26 U.S.C. §§ 6221 to 6231 16
28 U.S.C. 1254(1) 2

Miscellaneous

Act Sec. 1535, H. R. Conf. Rep. No. 841,
99th Cong., September, 18, 1986. 8
Act Sec. 7721, H. R. Conf. Rep. No. ___,
REVENUE RECONCILIATION ACT OF 1989,
CCH CURRENT LAW HANDBOOK EDITION,
p. 469, Commerce Clearing House, Inc. (1989) 23
Conference Committee Report No. 99-841 8
Deficit Reduction Act of 1984, P.L. 98-369 7
Economic Recovery Tax Act of 1981 2
Revenue Reconciliation Act of 1989,
Pub. No. 101-239, 103 Stat. 2106 2

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PETITION FOR WRIT OF CERTIORARI

Harold Chakales and Linda Carol Chakales, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 79 F.3d 726, and is reproduced verbatim in the Appendix attached hereto at pages App. 2 - App. 9, *infra*. The Memorandum Opinion of the United States Tax Court is reported at 68 T.C.M. (CCH) 479, and is reproduced verbatim in the Appendix attached hereto at pages App. 10 - App. 19, *infra*. The Decision of the United States Tax Court is unreported, but is reproduced verbatim in the Appendix attached hereto at page App. 20, *infra*.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit was entered on March 27, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The pertinent statutory provisions are reprinted in the Appendix attached hereto beginning at the following pages:

26 U.S.C. § 6621(d) for 1984 (before 1986 amendment) ..... App. 21
26 U.S.C. § 6621(c) for 1986) after 1986 amendment) ..... App. 22
26 U.S.C. § 6653(a) (as amended in 1981) ..... App. 24

STATEMENT OF THE CASE

This case arises from the decision of the United States Circuit Court of Appeals for the Eighth Circuit ("Eighth Circuit") affirming the United States Tax Court's ("Tax Court's") automatic application of the negligence penalties formerly provided in 26 U.S.C. §[1] 6653(a)[2] and the penalty interest formerly provided by § 6621(c) with respect to "tax-

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[1] Unless otherwise indicated all references to the Internal Revenue Code, I.R.C., the Code, section or §, shall be to the designated section of 26 U.S.C., as amended and effective for the years at issue.

[2] For tax years 1979 and 1980 Section 6653(a) provided a 5% penalty with respect to an entire deficiency to the extent any part of that deficiency was the result of "negligence" or intentional disregard of the rules and regulations. Section 6653(a) was amended in 1981 as part of the Economic Recovery Tax Act of 1981 and replaced with § 6653(a)(1), which was substantially the same as old § 6653(a), and § 6653(a)(2), which added a new, highly punitive element to the negligence penalty equal to 50% of the interest on any portion of the deficiency directly attributable to negligence. The Revenue Reconciliation Act of 1989, Pub. No. 101-239, 103 Stat. 2106, repealed the negligence penalty as a separate penalty, but the portion of any tax deficiencies directly attributable to negligence is now included in determining the portion of any deficiency subject to what is now § 6662, the Accuracy-Related Penalty, which was enacted as part of the Revenue Reconciliation Act of 1989. The Revenue Reconciliation Act of 1989 is applicable only to returns due after December 31, 1989.

motivated transactions" to tax deficiencies attributable to a specific investment program without reasonable consideration of the individual taxpayer's facts, circumstances, conduct and intent. Although Dr. Chakales pursued an extensive course of due diligence before both (i) investing in and (ii) adopting a reporting position on his tax returns with regard to the consequences of his investment, the Tax Court held, and the Eighth Circuit concurred, his efforts were insufficient to serve as a defense to the negligence penalty. The Tax Court and the Eighth Circuit have also held that the taxpayer's personal motive is not relevant to determining whether an investment is a "sham" for purposes of the penalty interest for tax motivated transactions.

1. Statement of the Facts.

a. *Facts re Dr. Chakales.*

The Chakales' are among thousands of unfortunate investors defrauded in the FWGS investment program which was the subject of the Opinions in *Freytag v. Commissioner*, 89 T.C. 849 (1987), *aff'd.* as to four of nine Petitioners, 904 F.2d 1011 (5th Cir. 1990), *aff'd.* 501 U.S. 868 (1991) (the Tax Court Opinion shall be cited hereafter as "*Freytag I*" and the Fifth Circuit's Decision as "*Freytag II*").

Dr. Chakales was an orthopaedic surgeon with no experience in finance, economics, or trading financial securities or forward or future contracts in financial securities. *[Tr.107,109.]* In 1980, Dr. Chakales was contacted by Mr. Coates, his friend and personal banker of many years, about a potentially profitable investment opportunity. Mr. Coates introduced Dr. Chakales to Mr. Marshall, a securities broker and a friend and business associate of many years. Mr. Marshall was registered with the NASD as both a representative and a principal, held an accounting degree, had obtained an MBA from Harvard Business School in 1971, had practiced as a CPA with Ernst & Ernst, a "Big Eight" accounting firm, and had been in the securities business continuously since 1966. *[Tr.14,111,118.]*

Another meeting took place in February, 1980, to which Dr. Chakales brought his longtime friend and tax and business advisor, Mr. Plastiras. Dr. Chakales knew that Mr. Plastiras had been a tax attorney since 1961 with an accounting degree, held an LLM in taxation from Georgetown University, had been employed by the chief counsel's office of the IRS in Washington from 1961 through 1964. *[Tr. 19,20,62-64.]*

Mr. Plastiras' role was to ensure that the transaction had economic reality and was not just another "tax shelter," and to review and render an opinion as to the tax aspects of the transaction. At that meeting, Mr. Plastiras received a brochure, a tax opinion, and a copy of the Arthur Andersen audited financial statement for FWGS.*[Tr.28,65,116.]*

Mr. Plastiras took the materials he had been given back to his law firm and divided the documents and the responsibility for review of the securities aspects and tax aspects of the investment between himself and his partner, Mr. Davidson. Mr. Plastiras did not recognize the law firm that had rendered the tax opinion and, therefore, had the opinion researched and came to his own conclusions. Mr. Plastiras reviewed the underlying authorities cited in the tax opinion and considered the issues of economic substance, sham, and profit motive as well as the technical aspects. Mr. Plastiras rendered a favorable opinion concurring with that in the prior tax opinion. *[Tr.66-67,72-78,121.]*

Mr. Davidson reviewed the securities aspects, including the *bone fides*, of the transactions, as reflected in the documents he had received. Mr. Davidson was graduated from the University of Arkansas School of Law and had been in practice since 1960, and with Mr. Plastiras, since 1964. Mr. Davidson had done extensive work in the securities area and had been the Acting Securities Commissioner for the State of Arkansas. Mr. Davidson prepared a memorandum expressing his opinion regarding the *bona fides* and securities aspects of the transactions. Mr. Davidson very descriptively expressed his opinion that the transactions had economic reality. Mr. Plastiras conveyed this information and advice to Dr. Chakales who rendered favorable tax and securities opinions with regard to the FWGS transactions. *[Tr.67-72,75-78,94-95,119-120.]*

Mr. Plastiras was familiar with the firm that prepared Dr. Chakales' tax returns for 1980 and 1981. It was Mr. Plastiras' opinion, as a tax attorney, that the review procedures of that firm were competent and thorough. Dr. Chakales had provided the accounting firm with his monthly statements and trade confirmations from FWGS. *Id.*

Dr. Chakales had only a basic understanding of the underlying mechanisms presented to him as being the structure of the FWGS investments. It was Dr. Chakales' understanding, at the time of the investment, that (i) the underlying transactions were very complex, (ii) the degree of volatility, and therefore potential profit or loss, would depend upon the degree of risk he wanted to take, (iii) to effectively

invest with FWGS, he needed only to tell them the amount of money he wanted to invest, the direction he believed interest rates would go, and the amount of risk he wished to take, (iv) the investment had the potential to double or triple his cash investment, and (v) the downside risk of trading through the FWGS program was less risky than the trading he had previously done. Based on the tax and securities opinions of his long-standing legal and tax advisor, Dr. Chakales made his investment in FWGS. *[Tr. generally.]*

At some point in either 1983 or 1984, Dr. Chakales received from the IRS a statutory notice of deficiency regarding tax years 1980 and 1981 asserting (i) deficiencies based on his claimed deductions arising from his FWGS investment and (ii) negligence penalties pursuant to what was then § 6653(a). A petition for redetermination was timely filed in the United States Tax Court.

b. *Facts re First Western Government Securities and Related Test Cases.*

FWGS was formed in 1978 by ex-IRS agent Sidney Samuels to market purported investment opportunities in straddles in forward contracts to buy and sell securities issued by the Government National Mortgage Association ("Ginnie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). In fact, the straddle portfolios FWGS led taxpayer's to believe they were investing in were no more than a computer-generated program to bilk the taxpayers/investors out of their money. Over 3,000 taxpayers were bilked by FWGS and sought redetermination in the tax court of deficiency and penalty amounts asserted against them by the IRS for deducting the losses realized therefrom.

Several cases were chosen by the Tax Court to be consolidated for trial and to serve as the test cases for the remaining cases brought by the investors regarding the disallowance of the FWGS deductions. These cases were tried in a twelve week proceeding and are reported in *Freytag I.* In *Freytag I*, Special Trial Judge Powell delivered the opinion for the Court on October 21, 1987, holding that the following were the Court's "ultimate findings of fact:" (1) the transactions between First Western and its customers [investors] were illusory and fictitious and not bona fide transactions; (2) even if the transactions were bona fide transactions, the transactions were not entered into primarily, if not solely, for tax avoidance purposes; and (3) petitioners in the test cases where asserted by the Government claiming deductions

based on these transactions are liable for penalties under § 6653(a). *Id.* at 875-876.

With regard to § 6621(c), Judge Powell stated: "We have found that these transactions were illusory and fictitious, i.e., shams." *Id.*, at 887. Four of the nine *Freytag I* petitioners appealed to the United States Circuit Court of Appeals for the Fifth Circuit ("Fifth Circuit"). On July 6, 1990, Circuit Judge, now Chief Circuit Judge, Politz entered that Court's decision affirming the Tax Court in all respects. Judge Politz stated that the Tax Court's ruling was based "on the grounds that the program [FWGS] was composed of sham transactions or, alternatively, that the Taxpayers did not enter into these transactions primarily for economic profit." *Freytag II*, at 1012.

Specifically, Judge Politz stated that "[w]hether a particular transaction is a sham is a question of fact reviewed under the clearly erroneous standard." *Id.*, at 1016.

Petition for writ of certiorari was granted by this Court on other grounds. That opinion was reported at *Freytag I.*

2. *Chakales* Proceedings in the Tax Court and on Appeal.

Based on §§ 6213(a), 6214 and 7442, Dr. Chakales petitioned the Tax Court in 1984 for redetermination of the tax deficiency determined by the Internal Revenue Service (hereafter "IRS") for tax years 1980 and 1981 and the penalties asserted under §§ 6653(a), 6653(a)(1) and 6653(a)(2). His case was held in abeyance by the Tax Court until 1992 while test cases involving nine investors in First Western Government Securities ("FWGS") were ultimately decided. The § 6621(c) penalty provision was first raised in this case by the IRS in 1991. Dr. Chakales never requested a continuance of his case, yet it was not set for trial until nine years later in 1993.

Before trial, Dr. Chakales stipulated that the losses claimed from FWGS investments would not be deductible. Dr. Chakales repeatedly refused to stipulate that they constituted "shams" for purposes of § 6621(c). The only issues tried were whether he was liable for the § 6653(a) negligence penalties and the § 6621(c) additional interest penalty. The Tax Court found in favor of the IRS, and on August 24, 1994, entered its Decision. Timely notice of appeal was filed.

Based on the jurisdiction of the Eighth Circuit pursuant to §§ 7482(a)(1) and 7482(b)(1)(A), appeal was timely brought before that

Court. The Eighth Circuit issued its judgment on March 27, 1996, upholding the Tax Court's rulings.

REASONS FOR GRANTING THE PETITION

1. **Reasons Regarding the Question on Sham**.

a. *A brief history of § 6621(c).*

In 1984, Congress enacted the 26 U.S.C. § 6621(d) which authorized an increase in the interest rate (to 120% of the normal rate) on substantial understatements of tax attributable to tax motivated transactions. Section 6621(d) was applicable to interest accruing after December 31, 1984. A copy of § 6621(d), as enacted, is found in the Appendix attached hereto beginning at Page App. 21.

Section 6621(d) was amended and renumbered as § 6621(c) in 1986 when § 6621(c)(3)(A)(v) added "**any sham or fraudulent transaction**" to the definition of "tax motivated transactions," retroactive and applicable to interest accruing after December 31, 1984. Section 6221(c), as applicable to the subject matter of this Petition, was repealed in 1989.

b. *A conflict between the circuits exists as to the definition of "sham."*

A longstanding tenet of our tax law is that a transaction will not be given federal tax treatment if it is a sham. *Knetsch v. United States*, 364 U.S. 361 (1960). Unfortunately, to this day, there is no uniformly applied judicial definition of "sham," nor is it clear whether the meaning is uniform throughout the Code and Regulations.

Section 6621(c)(3)(A)(v), which added *"any sham or fraudulent transaction"* to the definition of "tax motivated transactions," was enacted ten years ago. Despite the fact that the tax motivated interest penalty was repealed for tax years after 1989, pending audits and cases affect thousands of taxpayers. Unfortunately for the courts as well as the taxpayers, no definition of "sham," for purposes of either § 6621(c) or general tax purposes, has ever been promulgated by statute, regulation or this Court. Surprisingly, few courts have even attempted a definition of the term. Of those who have, two radically conflicting groupings have evolved.

In the cases arising out of FWGS, the Tax Court has adopted § 6621(c)(3)(A)(v) as a *per se* no-fault penalty under the "sham" category if a transaction is found to have no economic substance.

Congressional intent behind the meaning of "sham" for purposes of § 6621(c) is found in Conference Committee Report No. 99-841, which discusses the addition of "sham and fraudulent transactions" to the definition of "tax-motivated transactions:"

> The Tax Court has recently held (*DeMartino v. Comm'r.*, T.C. Memo 1986-263 (June 30, 1986); *Forseth v. Comm'r.*, T.C. Memo 1985-279 (June 11, 1985) that sham transactions *that would be subject to this special interest rate were they not shams* are not subject to this special interest rate because they are shams. The conferees view it as anomalous that a genuine transaction (lacking the proper profit motive) would be subject to a higher interest rate, *while a sham transaction, which is significantly more abusive*, would escape the higher interest rate simply because it is a sham. Accordingly, the conference agreement, consistent with legislative intent in originally enacting § 6621(d) in 1984, explicitly adds sham or fraudulent transactions to the list of transactions subject to this higher interest rate.

Act Sec. 1535, H. R. Conf. Rep. No. 841, 99th Cong., September, 18, 1986.

The "sham" transactions to which the section is intended to apply are those "significantly more abusive" than genuine transactions which would otherwise be subject to the penalty if they were not "shams." This is inconsistent with a no-fault application to bogus transactions like a Ponzi scheme in which an investor is defrauded. These are not the "significantly more abusive" transactions contemplated by Congress. Inherent in the Committee Report is the requirement that the taxpayer must have known the transaction was a sham and therefore lacked any business purpose or profit motive.

The Tax Court and Eighth Circuit ruled as if Dr. Chakales stipulated that his transactions were "shams" and therefore they need look no further. Judge Powell held that "because Petitioner concedes that his transactions with First Western were identical to those in *Freytag*, additional interest under Section 6621(c) is applicable here." *Chakales* I, at 482, App. 15

The Tax Court has applied (i) a no-fault finding of "sham," and (ii) a *per se* application of § 6621(c) (3)(A)(v) to every FWGS related case which Petitioners' counsel can find has come before it.

In *all* instances, Judge Powell has essentially found the taxpayers *could not* have had a true primary profit motive because of the sham nature of FWGS transactions. Judge Powell has automatically affirmed all penalties in the following FWGS cases: *Gould v. Commissioner*, 67 T.C.M. 3013 (1994); *Durrett v. Commissioner*, 67 T.C.M. 2735 (1994), *aff'd in part* 71 F.3d 515, 518 (5th Cir. 1996); *Chamberlain v. Commissioner*, 67 T.C.M. 2992 (1994); and *Kozlowski v. Commissioner*, 66 T.C.M. 754 (1993).

In point of fact, Dr. Chakales repeatedly, and *expressly*, refused to stipulate that the transactions were "shams" or "identical" to those in *Freytag*. Dr. Chakales agreed to stipulate that the losses and gains would not to be recognized in income. The parties agreed to include in the record of this case the transcript of the April 27, 1993, pre-trial conference in a related FWGS case, *Durrett*. The stipulation placed in the record was limited to precisely the following:

> MR. REDDING: ...As I have said, I will stipulate that we entered into forward contracts with First Western Government Securities in Freddie Macs and Ginnie Maes subject to the same internal workings of First Western Government Securities as occurred in *Freytag*.
>
> THE COURT: All right. So then, the testimony at the trial will be what your people may be - your clients may be - saying, if I understand this correctly, that they put some additional things on their dealings that don't take them out of the deficiency of the thing, but for the purposes of negligence or whatever, differentiate them from the people in *Freytag*.
>
> MR. REDDING: And, in fact, to show that they were, to use your analogy, subject to what amounted to a Ponzi scheme, rather than that they were in fact parties - knowingly parties - to "fraudulent" or illusory transactions. They thought these transactions had substance.
>
> THE COURT: Well, I think - I am not - we may be getting into self-defeating - **but I always think that most of the petitioners thought that there was some substance in there. They may not have understood, but they thought that there was something there.**
>
> MR. REDDING: I agree, Your Honor. And I believe that to be a serious issue when addressing 6621(c).

> THE COURT: I think if they did not think that that they would fall under more or less the same position that I indicated that McCoin and Freytag may have fallen into. They faced more than just negligence. Well, I think I understand, at least, the points.

Transcript of Pretrial hearing in *Durrett I*, April 27, 1993. [Emphasis added.]

Some FWGS investors who have had related cases docketed before the Tax Court have indeed stipulated that their transactions were "shams" based on the courts' determinations in *Freytag I* and *Freytag II*. With or without understanding the legal nature of the term, however, once stipulated, cannot argue with the court's determination of "sham." But, in this case as well as in *Chamberlain* and *Durrett*, the investors specifically refused to stipulate to sham.

The refusal to so stipulate was precisely because Petitioners assert that the proper legal definition of "sham," based on the case law to date and congressional intent, is "a transaction which is both without economic substance and with regard to which the taxpayer had no profit motive." This definition of "sham" mandates that Dr. Chakales' profit motive *must* be taken into account even when a *transaction*, or its form, is found to have no economic substance as in the FWGS Ponzi scheme.

c. *The Federal Circuit Courts of Appeal, United States Court of Federal Claims, Tax Court and other lower courts apply an array of various and conflicting tests and definitions to the determination of "sham."*

A major source of confusion regarding the determination of "sham" is the tendency of the courts and the parties to be imprecise in their use of the term. Anything that appears false or misleading is often referred to as a "sham." Any transaction in which there is no economic substance *or* in which the taxpayer lacks sufficient profit motive is often referred to as a "sham." Any transaction in which there is no economic substance *and* in which the taxpayer lacks sufficient profit motive is often referred to as a "sham."

"Sham transactions" were a part of the legal tax landscape long before the enactment of § 6621(c) and will continue to be long after § 6621(c)'s repeal in 1989. The seminal case addressing "sham" was *Gregory v. Commissioner*, 293 U.S. 465 (1935). The tests currently applied to identify a "sham transaction" arise from a struggle by the courts to determine the proper emphasis on the business

purpose/intent/motive of the taxpayer and the economic substance of the transaction itself. This issue was addressed by this Court, though not in the context of § 6621(c), in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

The current split between the federal circuit courts, Tax Court, and Claims Court arises over whether or not a taxpayer's personal motive or intent has any relevance in a determination that a transaction is or is not a "sham" for federal tax purposes. Petitioners assert that the proper test for "sham" is two-pronged, requiring that (1) the transaction must be without economic substance, *and* (2) the *taxpayer* must have been *without a profit or business motive*.

(1) Cases Adopting Two-Prong Approach:

The two-prong approach, requiring an examination into the nature of the transaction as well as the personal intent and motivation of the taxpayer/investor, has been accepted and utilized by the Second, Fourth, Fifth, Sixth, Ninth and District of Columbia federal circuit courts of appeal. The key cases articulating this two-prong test are:

1. *Gilman v. Commissioner*, 933 F.2d 143, 148, (2nd Cir. 1991), cert. denied (1992). (Found that the Tax Court *did not* demand that the taxpayer demonstrate *both* business purpose *and* economic substance, but examined *each* prong separately and concluded that Gilman *lacked a business* purpose *and* that the transaction lacked economic substance; therefore, the Tax Court applied the sham analysis *consistent with the guidelines of the Second Circuit*).

2. *Hunt v. Commissioner*, 938 F.2d 466, 471 & n. 5, (4th Cir. 1991). (Held that to treat a transaction as a sham, the court must find that (i) the taxpayer was motivated by *no business purposes* other than obtaining tax benefits in entering the transaction, *and* (ii) that the transaction has no economic substance because no reasonable possibility of a profit exists.

3. *Lukens v. Commissioner*, 945 F.2d 92, 99 (5th Cir. 1991). (Held that "[a] sham or fraudulent transaction includes transactions that were not entered into for profit *and* are without economic substance.")

4. *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989). (Held that because the Tax Court examined the *taxpayer's* profit motive *and* the economic substance, finding that the [taxpayers] did not have *an actual and honest profit objective*, *and* the transactions were devoid of

economic substance, the Tax Court's analysis is correct and consistent with the analysis traditionally applied in the Sixth Circuit.)

5. *Skeen v. Commissioner*, 864 F.2d 93, 95, 96 (9th Cir. 1989). (Held that the Tax Court's finding that an investment was tax motivated *and* without economic substance or business purpose took into consideration Hathaway's *subjective intent* which "is indeed the decisive factor."

6.*Horn v. Commissioner*, 968 F.2d 1229 (DC Cir. 1992). (Held very significantly that "[t]he sham transaction doctrine is an important judicial device for preventing the misuse of the tax code; but the doctrine cannot be used to preempt congressional intent," citing two general factors to assess in determining whether a transaction was an economic sham: (1) did the transaction have a reasonable prospect, *ex ante*, for economic gain (profit),[10] and (2) whether the transaction was undertaken for a business purpose other than the tax benefits. The Court reasoned that a transaction undertaken for a non-tax business purpose will not be considered an economic sham even if there was no objectively reasonable possibility that the transaction would produce profits.

7. *Drobny v. United States*, ___ F.3d ___ (Fed. Cir. 1996). (Held that to treat a transaction as a "sham," the Court must find that the taxpayer was motivated by **no** business purposes other than obtaining tax benefits in entering the transaction and that the transaction has no economic substance because no reasonable possibility of a profit exists.) This 1996 decision even went so far as to hold that "[i]f the only expectation of profit is one based on tax deductions and credits, the transaction is not necessarily a sham. Profit is profit, and Congress intended the deductions and credits to induce investment."

8. Of particular note are the recent opinions of the Fifth Circuit in *Durrett II* and *Chamberlain II*. Chief Judge Politz recognized the two-prong test for "sham" when he quoted *Lukens, supra.*, for the proposition that with regard to § 6621(c), "[a] sham or fraudulent transaction includes transactions that were not entered into for profit *and* are without economic substance." *Durrett II*, at 1197, and *Chamberlain II*, at 732 (both quoting *Lukens*, at 99). [Emphasis added.] In *Chamberlain*, the Court clarified its holding with a footnote that stated, "In determining a profit motive we focus on the intent of the taxpayer, not that of the underlying entity or activity." *Chamberlain II*, at 733, n. 13. Chief Judge Politz's rulings as to the necessary

consideration of the taxpayer's profit motive in determining "sham" are of particular note because both cases arise from FWGS and it was Judge Politz who wrote the Fifth Circuit's Opinion in *Freytag II*.[3]

(2) Cases Adopting A No-Fault "Sham" Definition.

In contrast to the determinations of the Circuit Courts listed above, the First, Third, Sixth, Seventh, and Eleventh federal circuit courts of appeal have determined that the business or profit motive of the taxpayer has no place in the determination of whether or not a transaction is determined to be a "sham" for federal tax purposes.

1. *Mahoney v. Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987): Held that while "sham" is a term of art that has not been interpreted the same by all courts, if a transaction is a sham, then such niceties as whether it was 'primarily' for profit or whether the test is an objective or subjective one are simply not involved.

2. *Forseth v. Commissioner*, 845 F.2d 746 (7th Cir. 1988): Held that because the Tax Court determined that the transactions were a "sham," it never reached the "entered for profit" issue because in finding that the transactions were no more than preconceived "shams," the Tax Court relied on six factual factors, none related to profit motive or business.

3. *Chakales II*, at 728, App. 4 - App. 5: Held that because the Tax Court, based on *Freytag* I, found the underlying transaction to be a "sham," Dr. Chakales' motive was irrelevant and that " there is no basis for reading a separate state of mind requirement into the application of the sham test for purposes of section 6621(c)(3)(A)(v)."

4. *Lerman v. Commissioner*, 939 F.2d 44, 45 (3rd Cir. 1991), cert. denied, 112 S.Ct. 1940 (1992): Found that the Tax Court correctly determined that the transactions were shams, devoid of economic substance.

5. *United States v. Wexler*, 31 F3d 117 (3rd Cir. 1994): Determined that the general rule on sham transactions in the Third Circuit is, "If a

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[3] Although not an appellate court, the Claims Court has also clearly articulated its adoption of the two-prong test for sham, including examination of the taxpayer's motive or intent, in the recent case of *Transpac Drilling Venture, 1983-2 v. United States*, 32 Cl.Ct. 810, *aff'd* ___ F.3d ___ (Fed.Cir. 1996).

transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse."

6. *Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir.1989): Held that a transaction with the sole function of the production of tax deductions is a sham regardless of the taxpayer's motives.

Application of a test for "sham" within the Tax Court is schizophrenic. The Tax Court case adopting the two-prong analysis of "sham" was *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). Similarly, in *Braddock Land Co. v. Commissioner*, 76 T.C. 324 (1980), applying the sham transaction theory, the Tax Court found a purported cancellation of indebtedness lacking in **both** business purpose and economic substance and on that basis, disregarded it for federal tax purposes. Then, there are the cases such as *Chakales I*, *Durrett I*, and *Chamberlain I* where the court found profit motive irrelevant to "sham."

d. *A split exists between the federal circuit courts of appeal regarding the test to be applied in determining a taxpayer's "profit motive," as that term is used for purposes of § 6621(c).*

Among the circuit courts of appeal that recognize the two-prong test for determining "sham" there is a split as to what degree of "profit motive" is required. As stated by Judge Goffe in *Rice's Toyota World, Inc.*, "[t]he precise degree of business motive or economic substance that must be present in a transaction is not clearly defined." *Rice's Toyota World, Inc.*, at 202. Two distinct lines of analysis have emerged:

The Eighth Circuit, in *Chakales II*, held that profit motive was not even an element of the test, but went on to imply that even if it were an element of the test, Dr. Chakales would lose because it reaffirmed the Tax Court's determination that "[t]he only rational explanation for any of this is that petitioner entered into these transactions with the primary, if not sole, objective of obtaining the tax loss." *Chakales II*, at 729, App.5; quoting *Chakales I*, at 484, App. 18. That language can only be construed as *dicta* affirming Judge Powell's review of Dr. Chakales' motive based on a "primarily for profit" standard and not a simple *bona fides* profit motive standard.

The "sham" profit motive test is easily confused with the "primarily for profit" standard now applied to determination of deductibility under the general provisions of § 165. For deductibility under § 165, the test

has become "primarily for profit" based on *Fox v. Commissioner*, 82 T.C. 1001 (1984), in which the Tax Court held the degree of profit motive required under § 165 to be "primarily for profit," which is now the often quoted standard. It based its analysis as follows on a footnote to a 1930's decision of the United States Supreme Court.

> The language of section 165(c)(2) does not specify the degree of profit motive necessary to support a section 165(c)(2) loss deduction. An incidental profit motive is insufficient. *Ewing v. Commissioner*, 20 T.C. 216, 233 (1953), affd. 213 F.2d 438 (2d Cir. 1954). At the other extreme, it requires no citation of authority to state as well that profit need not be the sole motive.
>
> When a taxpayer enters a particular transaction with the mixed motives of obtaining a profit and obtaining tax benefits, the question exists whether profit motive must be the primary motive to satisfy section 165(c)(2), or whether the profit motive may be merely significant or substantial.
>
> For the purposes of this case, we proceed on the supposition, without deciding, that petitioner had some profit motive. The "primary" standard first appeared as a judicial gloss on the statutory language of section 165(c)(2) in *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).
>
> . . . .
>
> In a footnote, the Court cited examples and included the following sentence: "Similarly, the deductibility of losses under section 23(e) * * * may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit." (304 U.S. at 289 n. 5.)

Id., at 1019.

Although "primarily for profit" is the generally accepted test for **deductibility**, it should not be the test for determining whether or not a transaction is a "sham." That simply goes too far. Furthermore, it would be in direct conflict with the seminal case for the "sham" transaction doctrine where this Court stated that:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham*, 17 Wall. 496, 506; *Superior Oil Co. v. Mississippi*, 280

U.S. 390, 395-6; *Jones v. Helvering*, 71 F.(2d) 214,-217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Gregory, at 465.

As the Tax Court observed in *Rice's Toyota World, Inc.*:

> Once business purpose is established, the transaction should not be classified a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some modicum of economic substance. See also *Grodt & McKay Realty, Inc. v. Commissioner, supra*, at 1243.
>
> **Conversely, transactions devoid of economic substance are not always shams such as where a taxpayer mistakenly believes there existed a potential for profit.**

Id., at 203, no. 17. [Emphasis added.]

Surely a taxpayer-induced into a Ponzi scheme, even one offering major tax benefits, should not be subjected to extra penalties where he had a *bone fides*, but mistaken, belief that there existed a reasonable expectation of a profit. Loss of his deduction for his foolish economic loss is enough; penalizing him goes too far. This is especially true for transactions entered into and deductions claimed before *Fox* to which a retroactively amended retroactive penalty is being applied that was not even asserted by the Government until seven years after the Tax Court case was filed, as in *Chakales*. And *Chakales* is not alone. **This issue is presently very applicable to thousands, perhaps tens of thousands, of investors in partnerships now under audit, or even in court, who, because of the special rules under §§ 6221 to 6231 for partnership audits, may not even be aware that their deductions taken in 1982-1989 are being questioned by the IRS!**

2. Reasons Regarding the Negligence Question.

a. A Major Split exists between the courts of appeals on the degree to which a taxpayer must "second guess" his professional tax advisors.

There is a major split among the circuits as to what constitutes reasonable reliance on a tax advisor, ranging from (i) the proposition that if a taxpayer makes full disclosure to a professional tax advisor (*e.g.*, attorney or CPA) of all information available to him, he has done all that is expected of a reasonably prudent person, (ii) the proposition

that the taxpayer must not only give to the advisor all the information available to the taxpayer, but the taxpayer must also (a) ensure that the advisor is a qualified tax professional, with specific expertise in the transactions and tax law applicable to those transactions, and (b) verify that the advisor conducts an independent background investigation of the parties and facts related to the transaction.

The split between the circuits is dramatically evidenced by comparing the opinions by the Eighth Circuit Court of Appeals in this, the *Chakales* case, to the opinions of the Fifth Circuit Court of Appeals in *Chamberlain II*, 67 T.C.M. [CCH] 2992 (1994), and *Durrett*, because in all three cases, (i) the investors invested in purported forward contracts to buy or sell securities; (ii) there were no significant differences in the transactions; Special Trial Judge Carleton D. Powell conducted the trials and wrote the opinions. All three cases were limited to a defense against the imposition of penalties, the taxpayers having conceded that based on the facts disclosed in *Freytag* I, the deductions claimed by them were erroneous. In each case, the taxpayer asserted as a defense against negligence that he had reasonably relied on independent professional tax advice. In virtually verbatim identical Opinions, Judge Powell found the parties to be negligent and the taxpayers' reliance on their advisors to not have been reasonable. There were no major factual distinctions between the three cases as except that the *Chakales* facts were stronger than those in *Chamberlain*.

In *Chamberlain*, the Court found that Mr. Chamberlain was introduced to the FWGS transactions by Mr. Argus, whom he did not know very well. He did not know if Mr. Hargus had any qualifications to evaluate the investments. Mr. Chamberlain relied on Angus Bailey (referred to as "Angus" hereafter because another important person in this story is Mr. Bill Bailey, unrelated to Angus Bailey, who will be referred to as "Bill"), another FWGS investor who is a CPA familiar with the petroleum industry. Angus had learned of FWGS from Bill, with whom Angus discussed the tax advantages of FWGS investments. Angus never understood how the FWGS transactions worked and never made an independent investigation of FWGS. Bill is a practicing CPA and attorney but has no specialized knowledge in securities transactions and made no independent investigation of FWGS. Bill relied on Ronald Mankoff, an attorney who had prepared an opinion letter regarding the tax status of the partnership (but not the tax treatment of the transactions) through whom the FWGS investments were made. *Chamberlain I*, at 2993-2.

The Tax Court found that Mr. Chamberlain's reliance on the advice of Angus and Bill was not sufficient to avoid the negligence penalty, setting forth the test that:

> It must be shown that the expert had the experience and knowledge of the pertinent facts to render such an opinion on the subject matter. *[Citation omitted.]* Furthermore, it must be established that the person rendering the advice is independent and does not have an economic interest in giving the advice. *[Citation omitted.]*

Chamberlain I, at 2994.

Based on that test, the Court concluded that Mr. Chamberlain had failed to make an adequate independent investigation of FWGS and that his reliance on Angus, who in turn relied on Bill, was insufficient because Angus did not understand the transactions, and the taxpayer had not established that Bill was qualified to give advice on the *bona fides* of the FWGS program.

The Fifth Circuit reversed holding based **on the Tax Court's findings of fact** that Mr. Chamberlain's reliance was an adequate defense to avoid the negligence penalty. The Fifth Circuit analyzed the case as follows:

> Good faith reliance on professional advice concerning tax laws is a defense. The reliance must be objectively reasonable; taxpayers may not rely on someone with an inherent conflict of interest, or someone with no knowledge concerning that matter upon which the advice is given. In this regard, the Supreme Court noted that "when an accountant or attorney advises a taxpayer on a matter of tax law, such as whether liability exists, it is reasonable for the taxpayer to rely on that advice."
>
> Taxpayers sought the advice of a tax expert about claiming the loss. The expert advised that there was "a good faith, supportable position" concerning the deductibility of the loss. The Tax Court erred in finding taxpayers negligent for claiming the loss. The record reflects no basis for a finding or conclusion that it was not reasonable for taxpayers to rely on the expert's advice. "To require the taxpayer to challenge the [expert], to seek a second opinion,' or to try to monitor [the expert] on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." Because the

> taxpayers reasonably relied on the advice of a tax expert in claiming the loss, the negligence penalty should not have been imposed.

Chamberlain II, at 733 [Footnotes and internal citations omitted.]

Remarkably similarly, in *Chakales I* the Tax Court found the following facts: Dr. Chakales is a surgeon with no background in economics and/or finance. Dr. Chakales was introduced to Mr. Marshall (hereafter "Marshall") by Wayne Coates ("Coates"), a vice president at Dr. Chakales' bank. Coates informed Dr. Chakales that Marshall, a Harvard Business School graduate and CPA, had an investment opportunity "that might be worthwhile". Marshall met with Dr. Chakales and gave him the FWGS promotional materials. Marshall was a broker, primarily marketing fixed-income securities to institutions, employed by Haas Securities ("Haas"), who offered the FWGS program to some of its customers. Marshall was told that employees of Haas had visited FWGS and recommended the program. Marshall indicated that he had made some investigation of the FWGS program. Dr. Chakales knew Marshall received commissions from FWGS.

Later, Dr. Chakales met with Marshall and Mr. Plastiras ("Plastiras"). Plastiras is a tax lawyer with an LLM in taxation and former employee of the IRS national office who then represented Dr. Chakales. Marshall, Plastiras, and Dr. Chakales discussed the alleged tax aspects of the FWGS program. After the meeting, Plastiras took the FWGS materials and discussed them with his securities law partner, Walter Davidson ("Davidson"). Davidson prepared a memorandum based on his review of FWGS' brochure. Plastiras relied on Davidson's memorandum in advising Dr. Chakales. Plastiras did not contact First Western and had no knowledge of how the First Western program worked. Dr. Chakales never furnished Plastiras with any of the documents executed in the opening account with First Western, but proforma copies of all of the documents were included in the FWGS brochure relied on by Davidson. Plastiras apparently only personally reviewed a tax opinion contained in the material supplied.

While Dr. Chakales knew something about investment straddles and read the First Western brochure, he was unaware that First Western could set prices, that the prices were not published, or that the contracts were not traded on an open market, which facts were all later found in *Freytag*.. He did not know anything about "the internal workings of First Western" and he could not explain how a First Western portfolio

would generate a profit except that if he predicted interest rates accurately he could double or triple his money. *Chakales* I, at 481, App. 13.

Additional uncontroverted facts in the record show that after an independent review of the tax opinion proffered by FWGS, Plastiras advised Dr. Chakales that he concurred with the tax opinion. Tr. 66-72, 120. Additionally, Plastiras testified that he saw no indicia of sham in the proposed transactions (Tr. 75), accepted Davidson's memorandum as affirmative of the economic substance of the securities transactions (Tr. 69, 72), and saw no reason to investigate FWGS independently as a consequence of the credentials of Marshall, Haas, and Coates. Tr. 82.

Nevertheless, precisely as in *Chamberlain I*, the Tax Court concluded that:

> With regard to petitioner's reliance on experts, such reliance, standing alone, will not insulate a taxpayer from additions to tax for negligence. It must be shown that the expert had the expertise and knowledge of the pertinent facts to render such an opinion on the subject matter. *Freytag v. Commissioner*, 89 T.C. at 888. Furthermore, it must be established that the person rendering the advice is independent and does not have an economic interest in giving the advice.
>
> [Citation Omitted.]
>
> Petitioner's background is in medicine. He has no credentials in finance or economics. Prior to 1980, he made no investments in any transactions of the nature involved in this case, and he did not understand how the First Western program operated. Petitioner contends that he was entitled to rely on the advice of Marshall and Plastiras. Petitioner, however, did not hire Marshall to make an evaluation of First Western's program, and Marshall, as petitioner knew, was compensated by First Western for putting petitioner in the program. With respect to Plastiras, petitioner did not hire him to investigate First Western. Nor did petitioner investigate First Western. Indeed, when Davidson raised concerns, these were not followed up, and Plastiras, like petitioner, simply relied on Marshall. When the chaff is stripped away, petitioner essentially relied on the promoter's statements concerning the bona fides of these transactions. Our words in *Rybak v. Commissioner*, [91 T.C. 524, 565 (1988).], explain the situation:

> In these circumstances, petitioners did not rely on competent, independent parties; they did no more than inquire of the promoter if the investment was sound. Such reliance is not the type of activity which will overcome the addition to tax for negligence or intentional disregard of the rules and regulations. [Citation omitted.]

Chamberlain I, at 2994.

Judge Powell further relied on Chief Judge Politz's having sustained Judge Powell's imposition of the negligence penalties on several of the original test case petitioners. *Durrett I*. However, despite his former opinion in *Freytag II*, it was Chief Judge Politz who wrote both the *Durrett II* and *Chamberlain II* opinions reversing Judge Powell on the negligence penalties in FWGS penalty cases!

It is excruciatingly clear that Dr. Chakales' reliance was predominantly on Plastiras and that Plastiras' perceived failure to do adequate due diligence and failure to consider the Davidson memorandum as a warning were imputed to Dr. Chakales, and that Dr. Chakales' negligence was founded on his failure to second-guess Plastiras and scrutinize the competency of Plastiras to render advice on the tax treatment of forward contracts in government securities.

Although giving lip service to *United States v. Boyle*, 469 U.S. 41, (1985), the Eighth Circuit refused to consider whether or not the Tax Court had imposed the wrong standard for determining reasonable reliance as a defense. *Chakales II*, at 730, App. 8. The Eight Circuit, like the Tax Court, applied a standard that requires the taxpayer to seek not only a tax professional's advice, but requires the taxpayer to ensure that the professional is a specialist regarding the nature of the transaction with respect to which the tax advice is sought, to second-guess that advice, and to hire independent private investigators to conduct background investigations of the people with whom he makes investments.. The Eighth Circuit first limited the reasonable reliance defense to reliance "when that advice involves the application of the attorney's or accountant's relevant expertise," and found that had not occurred in this case. *Chakales II*, at 730, App. 8. Even more clearly, the Eighth Circuit's Opinion was based on its determinations that Dr. Chakales had not shown that Plastiras had done adequate due diligence in rendering his opinion that the transactions appeared to have economic substance and that he independently concurred with the

proffered tax opinion. This is demonstrated by the Eighth Circuit's following observations:

> Given these facts, Chakales "could not merely rely on the documents supplied by First Western, and further investigation was clearly mandated. If there had been any serious examination of the program '[n]o reasonable person would have expected * * * [the] scheme to work.' " 68 T.C.M. at 483 (quoting *Freytag*, 89 T.C. at 889) (internal quotation omitted).

Chakales II, at 729, App. 6.

> He [Plastiras] testified that he received First Western's materials, had lawyers in his firm research them and arrive at their own opinion, and received from one of his partners a hand-written office memorandum respecting the securities aspect of the investment.

Id., at 729, App. 7.

> The Tax Court found that Chakales did not hire Plastiras to investigate First Western, that when Plastiras' partner raised concerns they were not followed up [by Plastiras], and that Plastiras, like Chakales, simply relied on Marshall.

Id., at 730, App. 8.

> There is, moreover, no evidence that Plastiras researched the tax aspects of the transaction, much less that he investigated First Western or the manner in which the program operated. *See Leonhart v. Commissioner*, 414 F.2d 749, 750 (4th Cir. 1969) ("[T]o escape the penalty [on the ground of good faith reliance on the advice of an accountant] taxpayers must be able to show that the accountant reached his decisions independently after being fully apprised of the circumstances of the transactions.") *Cf. Chamberlain v. Commissioner*, 66 F.3d 729, 733 (5th Cir. 1995) (reversing penalty assessment where "[t]he [tax] expert advised that there was a good faith, supportable position concerning the deductibility of the loss."), *reh'g. denied.*

Id., at 730, App. 9.

This Court in *United States v. Boyle*, 469 U.S. 41 (1985) established the basic tenet that a taxpayer who relies on professional tax advice should not have to second-guess his advisor on fear of incurring penalties. *Id.*, at 251. That principle was sound then and is even more

important today. The income tax law has become so grossly complex that no person, regardless how educated or sophisticated, can reasonably be held to second- guess a trained tax professional. Frankly, even the professionals can often render only a "best-guess," as evidenced by the media's enjoyment every year of making much ado about presenting the same facts to multiple accounting firms and receiving a very high degree of variation in results.

Nevertheless, several circuits, like the Eighth Circuit, have clearly engrafted responsibility for the professional's lack of due diligence onto the taxpayer. This very important issue is ripe for clarification by this Court, and the *Chakales* case is the perfect vehicle. Dr. Chakales engaged a highly qualified tax attorney who had access to everything that Dr. Chakales had available and who, in turn, sought advice from his **specialist** partner on the securities aspects.

The resolution of a clear rule is of major importance because of the frequency with which this issue arises in the courts. Additionally, many cases are still pending in which the magnitude of the penalty is terible because it is based on the § 6653(a)(2) 50% of accumulated interest penalty applied from 1982 to 1989 when it was repealed and replaced in part because Congress found the penalties were too frequently asserted by the IRS and obviously because the cumulative effect of §§ 6621(c), 6653(a)(2), and 6659 penalties combined were unconscionable. The new Accuracy Related Penalty under § 6662 is 20% of the tax and does not permit cumulative penalties.

The Joint Committee Report stated that:

> The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined to routinely and automatically by the IRS. The committee expects that enactment of standardized exception criteria will lead the IRS to consider fully whether the imposition of these penalties is appropriate before determining these penalties.

Act Sec. 7721, H. R. Conf. Rep. No. ___, REVENUE RECONCILIATION ACT OF 1989, CCH CURRENT LAW HANDBOOK EDITION, p. 469, Commerce Clearing House, Inc. (1989)

As examples, for Dr. Chakales, the negligence penalty exceeded $80,000 and § 6621(c), another $80,000. For Mr. Durrett, until reversed by the Fifth Circuit, **each** penalty was in the range of $400,000. These

penalties may have been lawful, but they were certainly unconscionably high, especially with the burden of proof on the taxpayers. The IRS is still unmercifully pursuing them in thousands of open cases and examinations today!

The following cases and circuits appear to follow a very narrow reasonable reliance standard similar to the Eighth Circuit's in *Chakales*: *Lax v. Commissioner*, 95-2 U.S.T.C. ¶50,639 (3rd Cir. 1995), unpublished. (Advisor's expertise in tax law not sufficient where he had no special expertise in relevant industry.); *David v. Commissioner*, 43 F.2d 788 (2d Cir. 1995) (Reliance on accountant not reasonable due to lack of personal investigation and accountant's lack of expertise in relevant industry.).

The following cases and circuits appear to follow the more permissive reasonable reliance standard similar to the Fifth Circuit's in *Chamberlain II*: *Schrum v. Commissioner*, 33 F.3d 426 (4th Cir. 1994) (Preparation of returns by reputable accounting firm held at least facial evidence of reliance.); *Anderson v. Commissioner*, 62 F.3d 1266 (10th Cir. 1995) (Reliance on independent insurance agent paid commissions by seller held reasonable.); *McMurray v. Commissioner*, ___ F.2d ___, [93-1 USTC ¶50,107] (1st Cir. 1993); *Murphy v. Commissioner*, ___ F.2d ___, [93-1 USTC ¶50,054] (9th Cir. 1993); *Balboa Energy Fund 1981 v. Commissioner*, ___ F.3d ___, [96-1 U.S.T.C. ¶50,117] (9th Cir. 1996) (Partner's reliance on CPA's advice reasonable even though partnership established not to have adequate profit motive.); *Betson v. Commissioner*, 802 F.2d 365 (9th Cir. 1986); *Gill v. Commissioner*, ___ F.3d ___, [96-1 U.S.T.C. ¶50,138] (6th Cir. 1996). (Cites *Chamberlain II* and appears to adopt 5th Circuit's test.); *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993) (But holds reliance not reasonable when advisor is promotor or agent or promotor.).

An additional subsidiary question with respect to which there is also a split among the circuits is whether reliance can be placed on the professional advice of any person paid commissions by the seller of the investments. The split is apparent when comparing *Chakales II* with *Anderson, supra.* In *Chakales II*, reliance of Marshall was held *per se* unreasonable because he received fees for selling the FWGS investments, even though he was an independent licensed securities broker doing business through an independent securities firm and had a sound reputation. In *Anderson*, the Court found that the independence of a licensed independent insurance agent was sufficient to permit reasonable reliance on the agent even though the agent was paid

commissions on sale of the investment. He was neither the promotor nor an agent of the promotor. His regulated professional independence was respected by the Court Should this not also have been true of Mr. Marshall? Can a taxpayer never rely on an offering memorandum or prospectus or any opinion at a seller's cost? If not, why then are such materials often required by the SEC and other regulatory bodies? Reliance on professionals who are regulated and held to high ethical professional standards should be permitted, or the professions become meaningless.

CONCLUSION

For all the foregoing reasons, Petitioners' writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX TO PETITION FOR WRIT OF CERTIORARI

TABLE OF CONTENTS

Verbatim reproductions of text of:

Opinion Issued by the United States Court of Appeals for the Eighth Circuit On March 27, 1996, in *Chakales V. Commissioner*, 79 F.3d 726 (5th Cir. 1996) ..... App. 2

Memorandum Opinion Issued by the United States Tax Court on August 22, 1994, in *Chakales V. Commissioner*, 68 T.C.M. (CCH) 479 (1994), *aff'd.* 79 F.3d 726 (8th Cir. 1996) ..... App. 10

Decision Entered by the United States Tax Court on August 24, 1994, in *Chakales V. Commissioner*, 68 T.C.M. (CCH) 479 (1994) ..... App. 20

Text of Statutory Provisions Involved ..... App. 21

- 26 U.S.C. § 6221(d), as enacted by the Deficit Reduction Act of 1984, P.L. 98-369., 98 Stat. 494 ..... App. 21
- 26 U.S.C. § 6221(c), as renumbered and amended by §§1511(a)(1) and 1535(a) of the Tax Reform Act of 1986, P.L. 99-514 ..... App. 22
- 26 U.S.C. § 6653(a), as amended and effective for tax year 1981 ..... App. 24

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 95-1742

Harold Chakales,	§	
Linda Carol Chakales,	§	
Appellants,	§	
	§	
v.	§	Appeal from the United
	§	States Tax Court
Commissioner of Internal	§	
Revenue,	§	
Appellee.	§	[PUBLISHED]

Submitted: December 13, 1995

Filed: March 27, 1996

Before, BOWMAN and LOKEN, Circuit Judges, and SCHWARZER * District Judge.

SCHWARZER, District Judge:

Taxpayers Harold and Linda Carol Chakales ("Chakales") appeal from a decision of the United States Tax Court upholding the assessment of penalty interest by the Commissioner of Internal Revenue. *Harold Chakales and Linda Carol Chakales v. Commissioner* [CCH Dec. 50,062(M)], 68 T.C.M. (CCH) 479 (1994). We have jurisdiction under 26 U.S.C. § 7482(a) and affirm.

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* The HONORABLE WILLIAM W. SCHWARZER, Senior United States District Judge for the Northern District of California, sitting by designation.

BACKGROUND

Chakales was among several thousand taxpayers who participated in a program operated by First Western Government Securities ("First Western") involving straddle transactions of forward contracts to buy and sell securities issued by the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation. The Commissioner's disallowance of the participants' resulting tax losses on the ground that the program was a sham was upheld in *Freytag v. Commissioner*, 904 F.2d 1011, 1015-17 (5th Cir. 1990), *aff'd on other grounds*, 501 U.S. 868 (1991). As summarized by the Fifth Circuit in that case:

> First Western's absolute authority over the pricing and timing of the transactions that occurred in the self-contained market of its own making enabled it to achieve the tax losses desired by its investors with uncanny accuracy. The Tax Court's recognition that First Western's program made available to its investors an essentially risk-free opportunity to purchase tax deductions cannot be labeled clearly erroneous.

Id. at 1016 (citation omitted).

Chakales does not contest the disallowance of the losses, conceding that *Freytag* controls the treatment of his transactions. He contends, however, that the Tax Court erred in upholding the Commissioner's assessment of penalties. The Commissioner determined that Chakales was liable for a penalty under 26 U.S.C. § 6653(a) for negligent underpayment of the tax. In addition, before the Tax Court, the Commissioner contended that an additional interest penalty was due under 26 U.S.C. § 6621(c) for a substantial underpayment of tax due to a tax-motivated transaction. The Tax Court upheld both assessments.

THE SECTION 6621(c) PENALTY

Section 6621(c) provides for an interest rate of 120 percent on any "substantial underpayment attributable to any tax motivated transactions" (i.e., in excess of $1,000), and states in relevant part: "[T]he term tax motivated transaction' means ... any sham or fraudulent transaction." 26 U.S.C. § 6621(c)(3)(A)(v). The Tax Court, basing its determination on the Fifth Circuit's holding in *Freytag* that these

transactions were shams, sustained the assessment of the penalty.[1] 68 T.C.M. at 482. It rejected Chakales's argument that the pen[* 728] alty cannot be assessed in the absence of a finding that the taxpayer lacked a profit motive. It went on, however, to find that Chakales in fact lacked a profit motive.

We review the Tax Court's legal conclusions de novo but accept its findings of fact unless clearly erroneous. *Chase v. Commissioner*, 926 F.2d 737, 740 (8th Cir. 1991). " 'A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.' " *Id.* (quoting *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948)).

Under the plain language of the statute, a tax motivated transaction "means ... [inter alia] *any* sham ... transaction." 26 U.S.C. §6621(c)(3)(A)(v)(emphasis added). The Commissioner has authority, therefore, to assess the penalty simply upon a finding that a transaction was a sham. *See Howard v. Commissioner*, 931 F.2d 578, 582 (9th Cir. 1991) (affirming a penalty under section 6621(c)(3)(A)(v) where the Tax Court found the underlying transaction "to be a sham."). Chakales contends that the taxpayer's state of mind is always relevant in the determination of whether a transaction was tax motivated. He relies principally on *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990). However, *Heasley* did not arise under the "sham transaction" provision of section 6621. In that case the penalty was assessed under the catch-all provision of section 6621(c)(3)(B) and an IRS regulation defining a "tax motivated" transaction as one "not engaged in for profit." *Id.* at 385; 26 C.F.R. § 301.6621-2T, Q-4, A-4 (2). Heasley had invested--and lost--a substantial sum in a scheme represented by his investment adviser as expected to produce future profits. The court of appeals held that the tax court had erred in solely considering that the plan had generated only tax deductions and credits but no profits. It held that "the tax court also should have considered the Heasleys' intent when determining whether the Heasleys did not engage in the transaction for profit." *Id.* at 386. *Heasley*, therefore, does not address the issue in this case nor do the other decisions cited by Chakales.

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[1] The Commissioner assessed section 6621(c) penalty interest in *Freytag*. The Tax Court upheld the assessment on the ground that the transactions were a sham. *Freytag v. Commissioner*, 89 T.C. 849, 886-87 (1987). The court of appeals did not address the issue in its opinion.

Section 6621(c)(3)(A)(v) by its terms authorizes the assessment of a penalty against a taxpayer participating in any sham transaction. Chakales does not dispute the Commissioner's disallowance of the losses based on the characterization of the transactions as sham. There is no basis for reading a separate state of mind requirement into the application of the sham test for purposes of section 6621(c)(3)(A)(v).

Chakales argues further that "[b]ecause this penalty applies at the investor level, that is the place to examine the 'motivation.' A defrauded investor is not subject to a penalty because he was unsophisticated enough to be victimized." Appellant's Brief at 47. We need not decide the appropriate application of section 6621(c)(3)(A)(v) to the case of an innocent victim of a fraudulent scheme who entered it in good faith for profit. This is not such a case. The Tax Court made specific findings rejecting Chakales' assertion of a profit motive. It found that he was aware of "[t]he raison d'etre of the program ... to convert ordinary income into long-term capital gains and defer the payment of taxes." 68 T.C.M. at 483. It found that Chakales had no understanding of the transactions, that he did not follow his account with First Western but submitted a request for a tax loss to First Western and had no taxes withheld from his substantial income from wages,[2] and that he could not explain how he expected to make a profit by requesting a [*729] loss in one year and an offsetting gain in the next. After reviewing Chakales' course of conduct with respect to his investment, the court found that "[t]he only rational explanation for any of this is that petitioner entered into these transactions with the primary, if not sole, objective of obtaining the tax loss." *Id.* at 484. That finding is not clearly erroneous. *See Lukens v. Commissioner*, 945 F.2d 92, 99-100 (5th Cir. 1991).

THE SECTION 6653 PENALTY

Section 6653 provides that "[i]f any part of any underpayment ... is due to negligence ... there shall be added to the tax an amount equal to

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[2] Chakales' explanation for the lack of withholding on his annual wages in the two years at issue ($300,000 and $400,000, respectively) was that "[h]e borrowed from his firm throughout the year and bonused an appropriate amount at year end, basing his withholding on December 30 or December 31 on the totality of facts then known." Appellant's Brief at 37.

5 percent of the underpayment."[3] 26 U.S.C. § 6653(a)(1). "[T]he determination of a negligence penalty is presumptively correct, and the taxpayer bears the burden of proving that it was improperly imposed." *Chase*, 926 F.2d at 740; *see also Freytag*, 904 F.2d at 1017. Thus the burden is on the taxpayer to prove that he did not fail to exercise due care or do what a reasonable and prudent person would do under similar circumstances. *Goldman v. Commissioner*, 39 F.3d 402, 407 (2nd Cir. 1994). "In addition, because the tax court's decision involved a factual determination, it will not be disturbed on appeal unless clearly erroneous." *Chase*, 926 F.2d at 740.

The Tax Court found Chakales to have admitted that he did not understand these transactions which involved forward contracts to purchase and sell millions of dollars of securities, with ratios of tax losses to payments from 8:1 to 16:1. 68 T.C.M. at 483. Given these facts, Chakales "could not merely rely on the documents supplied by First Western, and further investigation was clearly mandated. If there had been any serious examination of the program '[n]o reasonable person would have expected *** [the] scheme to work.' " 68 T.C.M. at 483 (quoting *Freytag*, 89 T.C. at 889) (internal quotation omitted).

Chakales contends, however, that he reasonably relied on the advice of experts, to wit, Charles Frederick Marshall and George Plastiras. Marshall was a broker employed by a securities firm. He introduced Chakales to the First Western program, presenting him with the documents which Chakales later completed and sent to First Western. Chakales knew that Marshall received a commission from First Western for selling the program to him. With respect to Marshall, the Tax Court held that reliance on "the promoter's statements concerning the bona fides of these transactions ... 'is not the type of activity which will overcome the addition to tax for negligence.' ", 68 T.C.M. at 483 (quoting *Rybak v. Commissioner*, 91 T.C. 524, 565 (1988)). *See Goldman*, 39 F.3d at 408 (reliance on advice from person who signed the limited partnership agreement at issue as the partnership's sales representative was unreasonable).

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[3] For the taxable year 1981, section 6653(a)(2) provided an addition to tax in the amount of 50 percent of the interest payable with respect to the portion of the underpayment attributable to negligence.

Plastiras was an experienced tax attorney and accountant who had represented Chakales since 1964 in various business and estate matters, including their tax aspects. At Chakales' request, Plastiras met with him and Marshall late one afternoon to discuss the First Western program, including the risks involved and whether it had economic reality. He testified that he received First Western's materials, had lawyers in his firm research them and arrive at their own opinion, and received from one of his partners a hand-written office memorandum respecting the securities aspect of the investment. Plastiras made no investigation of First Western; as he put it, "I am just totally unaware about First Western. Forgive me."

Chakales' testimony described the advice he received from Plastiras as follows:

> Q. [D]id you retain his firm to render those opinions or that advice?
>
> A. Yes.
>
> Q. And what did he tell you the advice of his firm was?
>
> A. That it sounded like this was a very legitimate firm, and that there was an opportunity to make some money.
>
> Q. And what did he tell you about the tax opinion that [Marshall gave to you]? ...[*730]
>
> A. He thought that the tax opinion from Arthur Andersen was reasonable.
>
> Q. The tax opinion from Arthur Andersen?
>
> A. Well, whatever it was. I am not sure. That he thought that this was a reasonable investment, as a taxpayer.
>
> Q. Did he give you an opinion about the tax treatment of the transactions?
>
> A. What do you mean by tax--an opinion as to tax treatment?
>
> Q. You gave him three documents ...
>
> A. One was ... a legal opinion from a law firm.
>
> Q. What was the legal opinion from the law firm about?
>
> A. Maybe that was the tax--that was about the securities, I thought. I may be a little confused.

Q. And what did he tell you about that legal opinion from the law firm?

A. That he didn't know the law firm, and that his law firm looked over it and thought that it was reasonable ... [and that it] [c]oncurred with their opinion.

(Joint Appendix 182-84.)

The relevant testimony of Plastiras was as follows:

Q. And what did you advise him or did you give him any advice as to whether or not this transaction had economic substance in reality? ...

A. Yes. In our judgment, it had economic risk, and that he could lose considerable amount of money. I was very much concerned more about the loss of money than the gain. I didn't want him to lose any money.

(Joint Appendix 161-62.)[4]

The Tax Court found that Chakales did not hire Plastiras to investigate First Western, that when Plastiras' partner raised concerns they were not followed up, and that Plastiras, like Chakales, simply relied on Marshall. 68 T.C.M. at 483.

In *United States v. Boyle*, 469 U.S. 241, 251 (1985), the Supreme Court laid down the controlling principle:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, ... it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.

The underlying premise is that a taxpayer may reasonably rely on advice when that advice involves the application of the attorney's or accountant's relevant expertise. That is not what occurred in this case. The "advice" Plastiras gave, on which Chakales now claims to have relied, was little more than a generalized statement that he could lose money on the transaction. Chakales himself was vague at best about

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[4] Plastiras did not prepare Chakales' tax returns, and there is no evidence that Chakales received or relied on advice from his tax accountants in claiming the disallowed losses.

just what "advice" he had received from Plastiras. *See Howard*, 931 F.2d at 582 ("Where no reliable evidence exists in the record suggesting the nature of any advice given, a finding of negligence is not erroneous."). There is, moreover, no evidence that Plastiras researched the tax aspects of the transaction, much less that he investigated First Western or the manner in which the program operated. *See Leonhart v. Commissioner*, 414 F.2d 749, 750 (4th Cir. 1969) ("[T]o escape the penalty [on the ground of good faith reliance on the advice of an accountant] taxpayers must be able to show that the accountant reached his decisions independently after being fully apprised of the circumstances of the transactions.") *Cf. Chamberlain v. Commissioner*, 66 F.3d 729, 733 (5th Cir. 1995) (reversing penalty assessment where "[t]he [tax] expert advised that there was a good faith, supportable position' concerning the deductibility of the loss."), *reh'g denied*.

The Tax Court's factual findings are not clearly erroneous and its conclusion that [*731] Chakales failed to carry his burden of proving that he exercised due care was not error.

Affirmed.

T.C. Memo. 1994-408

UNITED STATES TAX COURT

Harold Chakales and Linda Carol Chakales, Petitioners v. Commissioner of Internal Revenue, Respondent

Docket No. 12155-84. Filed August 22, 1994.

Thomas E. Redding and Charles B. Koerth, for petitioners. Lamont R. Olson, for respondent.

Memorandum Opinion

DAWSON, Judge: This case was assigned to Special Trial Judge Carleton D. Powell pursuant to section 7443A(b)(4) and Rules 180, 181, and 183.[5] The Court agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

Opinion of the Special Trial Judge

POWELL, Special Trial Judge: By notice of deficiency dated February 7, 1984, respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

		Additions to Tax	
Year	*Deficiency*	*Sec. 6653(a)*	*Sec. 6653(a)(1)*
1980	$82,104.24	$4,105.00	-0-
1981	56,214.00	-0-	$2,811.00

Respondent also determined that petitioners were liable for an addition to tax in the amount of 50 percent of the interest due on the deficiency for the taxable year 1981 pursuant to section 6653(a)(2). In a First Amendment to Answer, respondent raised the issue whether the deficiencies for 1980 and 1981 were substantial underpayments due to

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[5] Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

tax-motivated transactions and whether the increased rate of interest under section 6621(c) was applicable.

At the time the petition was timely filed petitioners resided in Little Rock, Arkansas.

The issues presented for decision are: (1) Whether the increased interest provisions of section 6621(c) apply; and (2) whether petitioners are liable for additions to tax under section 6653(a).

The facts may be summarized as follows. The deficiencies in this case result primarily from the disallowances of losses in the amounts of $205,714 and $210,390 claimed for the taxable years 1980 and 1981, respectively. The losses arise from alleged straddle transactions of forward contracts for Government-backed financial securities with First Western Government Securities, Inc. (First Western).

The First Western losses were the subject of this Court's opinion in *Freytag v. Commissioner*, 89 T.C. 849 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), *affd. on other grounds* 501 U.S. 868 (1991). After a lengthy trial, this Court found, based on that record, inter alia, that "The transactions between First Western and its customers were illusory and fictitious and not bona fide transactions." Id. at 875. This Court alternatively held that, even if the transactions had substance, they "were entered into primarily, if not solely, for tax-avoidance purposes." *Id.* at 876. Based on the finding that the transactions were not bona fide, this Court concluded that additional interest under section 6621(c) was due on the underpayments. *Id.* at 886-887.

In concluding that the transactions were not bona fide, this Court examined various aspects of the First Western program, including the risk of profit or loss, the hedging operation, the margins required and fees charged, the pricing of the forward contracts that were involved, and the manner in which the transactions were closed. In all of these areas we found that the First Western operations were deficient and not conducted as they should have been if bona fide financial transactions were being conducted. With respect to the losses, this Court noted:

> Petitioners' portfolios were constructed so as to achieve their desired tax losses. In this regard, the most important required data supplied by petitioners were their requested tax losses. Indeed, the program could not be implemented without the tax information. Thus, in analyzing the program from a profit

standpoint, from the first, the tax tail wagged an economic dog. * * * [*Id.* at 878.]

We also pointed out that there were other "gremlins" in First Western's world that dispelled the notion that these transactions were bottomed in financial reality--reversing transactions months later, confirmations being months late, transactions being made with no documentation, etc. *Id.* at 882.

In the case currently before the Court, petitioners concede that the transactions with First Western were conducted in the same way as the transactions discussed in *Freytag*, i.e., the same pricing algorithms were used, the transactions were closed in the same way, etc. They do not contest the disallowance of the losses claimed or the deficiencies arising therefrom. They do, however, contest the increased interest under section 6621(c) and the additions to tax for negligence under section 6653(a).

Petitioner Harold Chakales (petitioner) is a surgeon. He has no background in economics and/or finance. Prior to 1980 he invested in stocks, bonds, options, and real estate in a "moderate" way. His investments had not been very successful. In early January 1980, petitioner was introduced to Charles Frederick Marshall (Marshall) by Wayne Coates (Coates), a vice-president of a local bank. Coates informed petitioner that Marshall had an investment opportunity "that might be worthwhile". Marshall met with petitioner and gave him First Western promotional materials.

Marshall was a certified public accountant, but did not practice in that profession. In 1969, he went to Harvard Business School and since that time has been a broker, primarily marketing fixed-income securities to institutions. In 1979 Marshall was hired by Haas Securities (Haas) as a broker. Haas offered the First Western program to some of its customers. Marshall was told that some employees of Haas had visited First Western and recommended that Haas brokers sell the program. The standard procedure was for a customer to send executed First Western documents to Haas and Haas would forward the documents to First Western. Marshall received commissions from First Western based on the alleged investments. Petitioner knew that Marshall received compensation from First Western and he did not pay any fees to Marshall. While Marshall indicated that he had made some investigation of the First Western program, he was unaware that First Western used an algorithm in setting its prices, that under the

agreement First Western could set and change prices in its sole discretion, that the so-called "margin" was based on the requested tax preference, or that there was no market for First Western's contracts other than First Western.

Some months after Marshall's initial contact, petitioner met with Marshall and George Plastiras (Plastiras). Plastiras is a tax lawyer who had done some corporate, pension, and estate planning work for petitioner. Marshall, Plastiras, and petitioner discussed the alleged tax aspects of the First Western program. After meeting with Marshall, Plastiras took some of the First Western materials and discussed them with his partner, Walter Davidson (Davidson). Davidson worked in the securities law area. Davidson prepared an interoffice memorandum, based solely on his review of First Western's brochure, in which he noted that First Western operated "with little or no securities law regulations--a subject now being criticized by the SEC". He also warned that "you should raise the very legitimate question of the reliability and integrity of these folks [First Western]."

Although Plastiras relied on Davidson's memorandum in advising petitioner, he never contacted First Western and had no knowledge of how the First Western program worked or was supposed to work. Petitioner never advised Plastiras that he had requested a tax loss. Petitioner never furnished Plastiras with any of the documents that petitioner executed in the opening account with First Western. In giving advice that the First Western program was viable, Plastiras apparently only reviewed a tax opinion contained in the material supplied.

While petitioner knew something about investment straddle and claimed to have read the First Western brochure, he was unaware that First Western could set prices, that the prices were not published, or that the contracts were not traded on an open market. He did not know anything about "the internal workings of First Western" and he could not explain how a First Western portfolio would generate a profit.

On May 7, 1980, petitioner executed the standard First Western documents and sent them to Marshall with a check in the amount of $26,000 payable to First Western. Marshall forwarded them to First Western. The First Western documents show that initially a $200,000 ordinary loss and a $200,000 long-term capital gain for 1980 were requested. The long-term capital gain was changed to a short-term capital gain in the same amount for 1980. For that year, First Western generated an alleged ordinary loss in the amount of $205,714, and a

short-term capital gain in the amount of $200,557. On their 1980 Federal income tax return petitioners deducted the loss. The short-term capital gain was reported and used to partially offset a $331,711 short-term capital loss carryover. Although petitioner received wages in the amount of $300,000 from his professional association, no income taxes were withheld. Petitioners' 1980 Federal income tax return reported no tax liability.

Because all the alleged gains and losses were realized in 1980, there were no forward contracts open. Nonetheless, First Western's records show that a Dolores Green from Haas called and changed the interest rate forecast on January 30, 1981. First Western took no action. On April 10, 1981, First Western's records show that Marshall called and requested a $200,000 ordinary loss for 1981 and a long-term capital gain in a similar amount for 1983. On April 13, 1981, First Western sent petitioner a letter requesting an additional "margin" in the amount of $12,748. This request was repeated by another letter dated August 24, 1981, and by telephone on September 9, 1981. Notwithstanding these requests, petitioner did not send a check to First Western until December 31, 1981. In this regard, while petitioner testified that he regularly monitored the First Western account and made changes in the interest rate forecast, there is no record of any communication with petitioner in First Western's records other than the requests for additional money.

On their 1981 Federal income tax return, petitioners deducted an ordinary loss in the amount of $210,390 from petitioner's First Western transactions. In addition, petitioner deducted $5,157 as "investment expense." He received wages in the amount of $400,000 from his professional association, and no income taxes were withheld. Petitioners' 1981 Federal income tax return showed no tax liability.

1. Section 6621(c)

Petitioners contend that the increased interest under section 6621(c) is inapplicable to them, relying on *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), revg. T.C. Memo. 1988-408. Section 6621(c)(1) provides that, if there is a "substantial underpayment attributable to tax motivated transactions," the interest payable under section 6601 "shall be 120 percent of the underpayment rate". A substantial underpayment attributable to a tax-motivated transaction means "any underpayment of taxes * * * attributable to 1 or more tax-motivated transactions if the amount of the underpayment for such year * * * exceeds $1,000." Sec.

6621(c)(2). The term "tax motivated transactions" means, inter alia, "any sham or fraudulent transaction." Sec. 6621(c)(3)(A)(v). From a literal reading of the statute, if a transaction is determined to be a "sham", the increased interest applies.

In *Freytag v. Commissioner*, 89 T.C. 849, 887 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. on other grounds 501 U.S. 868 (1991), we sustained respondent's determinations that section 6621(c) applied to the First Western underpayments based on our finding that the transactions were "shams." Because petitioner concedes that his transactions with First Western were identical to those in *Freytag*, additional interest under section 6621(c) is applicable here. See *Howard v. Commissioner*, 931 F.2d 578, 582 (9th Cir. 1991), affg. T.C. Memo. 1988-531.

In *Heasley v. Commissioner*, T.C. Memo. 1988-408, this Court found that the transactions were not entered into for profit, and, therefore, under section 301.6621-2T Q&A-4, Temporary Proced. & Admin. Regs., 49 Fed. Reg. 50392 (Dec. 28, 1984), the increased interest under section 6621(c) was applicable. The Court of Appeals for the Fifth Circuit concluded, however, that the taxpayers had "the requisite profit motive." *Heasley v. Commissioner*, 902 F.2d at 386. While it is true that in *Freytag v. Commissioner*, 89 T.C. at 882-886, we held, in the alternative, that the transactions were not entered into for profit, we sustained the additional interest under section 6621(c) on the ground that the alleged transactions factually were illusory and fictitious, i.e., "shams", a finding affirmed by the Court of Appeals for the Fifth Circuit 904 F.2d at 1015-1016, and it is upon that ground that we sustain respondent's determinations here.

Petitioner, however, contends that for a transaction to be considered a sham under section 6621(c)(3)(A)(v), the transaction must be without economic substance and be entered into without a profit objective, citing *Heasley v. Commissioner, supra*. While, as discussed *infra*, we reject his contention that there was a profit motive, we neither read the Court of Appeals' opinion in *Heasley* nor its opinion in *Lukens v. Commissioner*, 945 F.2d 92, 99-100 (5th Cir. 1991), affg. *Ames v. Commissioner*, T.C. Memo. 1990-87, to stand for this proposition. When a transaction is the simple product of smoke and mirrors, it is a factual sham, regardless of whether the taxpayer may have thought that a profit might have been made. See *Cherin v. Commissioner*, 89 T.C. 986, 993-994 (1987). This is all that section 6621(c)(3)(A)(v) requires. See Statement of the Managers attached to the conference report, H.

Conf. Rept. 99-841, at II-796 (1986), 1986-3 C.B. (Vol. 4) 1, 796. Thus, *Heasley v. Commissioner*, supra, is inapposite.

2. Negligence

Respondent determined that additions to tax under section 6653(a) are due for negligence. For the taxable year 1980, section 6653(a) provides, in relevant part, that "If any part of any underpayment * * * is due to negligence or intentional disregard of rules and regulations * * * there shall be added to the tax an amount equal to 5 percent of the underpayment." For the taxable year 1981, section 6653(a) was amended, and the "5 percent of the underpayment" provision was redesignated as section 6653(a)(1). In addition, section 6653(a)(2) provided an addition to tax in the amount of 50 percent of the interest payable with respect to the portion of the underpayment attributable to negligence. "Negligence is a lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances." *Freytag v. Commissioner*, 89 T.C. at 887 (quoting *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), affg. on this issue 43 T.C. 168 (1964)); see also *Zmuda v. Commissioner*, 731 F.2d 1417, 1422 (9th Cir. 1984), affg. 79 T.C. 714 (1982). Petitioners have the burden of establishing that their actions were not negligent. See *Freytag v. Commissioner*, 904 F.2d at 1017.

Petitioners contend that the additions to tax under section 6653(a) are unwarranted. The gravamens of their contentions are that petitioner relied on expert advice and that his motive for entering into the transactions was not to avoid taxes.

With regard to petitioner's reliance on experts, such reliance, standing alone, will not insulate a taxpayer from additions to tax for negligence. It must be shown that the expert had the expertise and knowledge of the pertinent facts to render such an opinion on the subject matter. *Freytag v. Commissioner*, 89 T.C. at 888. Furthermore, it must be established that the person rendering the advice is independent and does not have an economic interest in giving the advice. *Rybak v. Commissioner*, 91 T.C. 524, 565 (1988).

Petitioner's background is in medicine. He has no credentials in finance or economics. Prior to 1980, he made no investments in any transactions of the nature involved in this case, and he did not understand how the First Western program operated. Petitioner contends that he was entitled to rely on the advice of Marshall and Plastiras. Petitioner, however, did not hire Marshall to make an

evaluation of First Western's program, and Marshall, as petitioner knew, was compensated by First Western for putting petitioner in the program. With respect to Plastiras, petitioner did not hire him to investigate First Western. Nor did petitioner investigate First Western. Indeed, when Davidson raised concerns, these were not followed up, and Plastiras, like petitioner, simply relied on Marshall. When the chaff is stripped away, petitioner essentially relied on the promoter's statements concerning the bona fides of these transactions. Our words in *Rybak v. Commissioner*, supra at 565, explain the situation:

> In these circumstances, petitioners did not rely on competent, independent parties; they did no more than inquire of the promoter if the investment was sound. Such reliance is not the type of activity which will overcome the addition to tax for negligence or intentional disregard of the rules and regulations. [Citation omitted.]

See also *Marine v. Commissioner*, 92 T.C. 958, 992 (1989), affd. without published opinion 921 F.2d 280 (9th Cir. 1991); *Patin v. Commissioner*, 88 T.C. 1086, 1130 (1987), affd. without published opinion 865 F.2d 1264 (5th Cir. 1989), affd. without published opinion sub nom. *Hatheway v. Commissioner*, 856 F.2d 186 (4th Cir. 1988), affd. sub nom. *Skeen v. Commissioner*, 864 F.2d 93 (9th Cir. 1989), affd. sub nom. *Gomberg v. Commissioner*, 868 F.2d 865 (6th Cir. 1989).

It is noted that these transactions could hardly be described as being run-of-the-mill, and petitioner admits that he did not understand the transactions. They involved alleged forward contracts to purchase and sell millions of dollars of mortgage-backed securities. See *Freytag v. Commissioner*, 89 T.C. at 862-863. There was no market for these contracts, and First Western was on both sides of the transactions. In discussing the First Western transactions, the Court of Appeals for the Fifth Circuit noted: "no reasonable investor would surrender total control of his or her ability to profit or lose unless satisfied that the risk of loss had been greatly diminished or eliminated." *Freytag v. Commissioner*, 904 F.2d at 1016 (quoting *Sochin v. Commissioner*, 843 F.2d 351, 356 (9th Cir. 1988), affg. *Brown v. Commissioner*, 85 T.C. 968 (1985)).

Furthermore, the ratio of the tax losses compared with the payments was huge, between 8:1 and 16:1, depending on how it is calculated. This latter fact was particularly important because, as the Court of

Appeals for the Ninth Circuit recognized in *Zmuda v. Commissioner*, 731 F.2d at 1422, during this period there was "extensive continuing press coverage of questionable tax shelter plans." As we noted in our opinion in *Freytag v. Commissioner*, 89 T.C. at 888, given this scenario, a taxpayer could not merely rely on the documents supplied by First Western, and further investigation was clearly mandated. If there had been any serious examination of the program "No reasonable person would have expected * * * [the] scheme to work." Id. at 889; cf. *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983), affg. per curiam T.C. Memo. 1981-675.

Finally, we note that petitioner's alleged profit motive for the First Western transactions is simply cut from whole cloth. The raison d'etre of the program was to convert ordinary income into long-term capital gains and defer the payment of taxes. Petitioner was clearly aware of this. Petitioner, however, steadfastly contends that he did not know about the request for tax losses that was supplied to First Western. This has a decidedly hollow ring. If we were to accept petitioner's argument, we would have to accept that the request for a tax loss, which was well tailored to his situation, materialized out of thin air. This would be particularly perverse because there were no taxes withheld from petitioner's substantial wage income, and we decline that invitation.

It is highly unlikely that anyone whose primary purpose was to make a profit would enter into this transaction when he lacked any understanding of what was going on. Petitioner, however, had no difficulty in claiming losses based on the alleged transactions. We find it equally inconceivable that, if he had even a fleeting profit motive, he would not have paid some attention to his First Western account. Yet, despite petitioner's protestations to the contrary, there is no evidence in First Western's files that petitioner followed the account. Finally, petitioner does not explain how he expected to make an economic profit by requesting a loss in one year and a gain in the same amount in the same year (1980), or a loss in 1981 and a gain in the same amount in 1983. The only rational explanation for any of this is that petitioner entered into these transactions with the primary, if not sole, objective of obtaining the tax loss.

Petitioner, relying again on Heasley, suggests that he did all that was necessary because he was an "unsophisticated" investor. It is true that the Court of Appeals for the Fifth Circuit in Heasley found that "moderate-income" and "unsophisticated" investors were not negligent when they failed to independently investigate an investment in a tax

shelter. *Heasley v. Commissioner*, 902 F.2d at 383-384. That, however, is not the case before us here.

In this regard, we are continually surprised to discover, after *Heasley*, how the definition of an "unsophisticated" and "moderate-income" investor has been expanded to include well-educated persons who have established or been engaged in lucrative businesses and professions. Indeed, if petitioner fits within that description, it would appear that at least some of the taxpayers in *Freytag* were similarly situated. But in *Freytag* the additions to tax for negligence were affirmed by the same court that had decided *Heasley* just a month before. *Heasley* does not shield petitioners from the additions to tax for negligence. Petitioners have not shown that they used due care, and respondent's determinations with respect to the additions to tax under section 6653(a) are sustained.

To reflect petitioners' concession of the deficiencies and our conclusions on the disputed issues,

Decision will be entered for respondent.

UNITED STATES TAX COURT
Washington, D.C. 20217

HAROLD CHAKALES and LINDA CAROL CHAKALES,	§	
Petitioners,	§	
v.	§	Docket No. 12155-84
COMMISSIONER OF INTERNAL REVENUE, Respondent.	§	

DECISION

Pursuant to the Court's Memorandum Opinion (T.C. Memo. 1994-408) filed August 22, 1994, it is

ORDERED and DECIDED: That there are deficiencies in and additions to petitioner's Federal income taxes as follows:

		Additions to Tax, I.R.C.		
Year	Deficiency	Sec. 6653(a)	Sec. 6653(a)(1)	Sec. 6653(a)(2)
1980	$82,104.24	$4,105.00	-0-	
1981	56,214.00	-0-	$2,811.00	50 percent of the interest due on $56,214

Petitioners are liable for increased interest under section 6621(c), I.R.C., due to the underpayment for 1980 and 1981.

/s/ Howard A. Dawson, Jr.
Howard A. Dawson, Jr.
Judge

Entered: /st/AUG 24, 1994

TEXT OF STATUTORY PROVISIONS INVOLVED

26 U.S.C. § 6221(d), as enacted by the Deficit Reduction Act of 1984, P.L. 98-369., 98 Stat. 494.[1]

(d) INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.

(1) IN GENERAL. In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

(2) SUBSTANTIAL UNDERPAYMENT ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS. For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) TAX MOTIVATED TRANSACTIONS.

(A) IN GENERAL.For purposes of this subsection, the term "tax motivated transaction" means

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), and

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.

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[1] 26 U.S.C. § 6221(d), as enacted, was applicable to interest accruing after December 31, 1984.

(B) REGULATORY AUTHORITY.The Secretary may by regulations specify other types of transactions which will be treated as tax motivated for purposes of this subsection and may by regulations provide that specified transaction being treated as tax motivated will no longer be so treated. In prescribing regulations under the preceding sentence, the Secretary shall take into account

(i) the ratio of tax benefits to cash invested,

(ii) the methods of promotion the use of this type of transaction, and

(iii) other relevant considerations.

(C) EFFECTIVE DATE FOR REGULATIONS.Any regulations prescribed under subparagraph (A)(iv) or (B) shall apply only to interest accruing after a date (specified in such regulations) which is after the date on which such regulations are prescribed.

(4) JURISDICTION OF TAX COURT.In the case of any proceeding in the Tax Court for a redetermination of a deficiency, the Tax Court shall also have jurisdiction to determine the portion (if any) of such deficiency which is a substantial underpayment attributable to tax motivated transactions.

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26 U.S.C. § 6221(d), as renumbered and amended by §§1511(a)(1) and 1535(a) of the Tax Reform Act of 1986, P.L. 99-514.[2]

(c) INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.

(1) IN GENERAL. In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the [~~annual~~] rate of interest established under this section shall be 120 percent of the

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[2] Section 6621(c)(3)(A), as enacted, was retroactive and applicable to interest accruing after December 31, 1984. All other amendments were made applicable for purposes of determining interest for periods after December 31, 1986.

underpayment rate established under this section [~~the adjusted rate established under subsection (b)~~].

(2) SUBSTANTIAL UNDERPAYMENT ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS. For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) TAX MOTIVATED TRANSACTIONS.

(A) IN GENERAL.For purposes of this subsection, the term "tax motivated transaction" means

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), [~~and~~]

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period, and

(v) **any sham or fraudulent transaction**.

(B) REGULATORY AUTHORITY.The Secretary may by regulations specify other types of transactions which will be treated as tax motivated for purposes of this subsection and may by regulations provide that specified transaction being treated as tax motivated will no longer be so treated. In prescribing regulations under the preceding sentence, the Secretary shall take into account

(i) the ratio of tax benefits to cash invested,

(ii) the methods of promotion the use of this type of transaction, and

(iii) other relevant considerations.

(C) EFFECTIVE DATE FOR REGULATIONS.Any regulations prescribed under subparagraph (A)(iv) or (B) shall apply only to interest accruing after a date (specified in such regulations) which is after the date on which such regulations are prescribed.

(4) JURISDICTION OF TAX COURT.In the case of any proceeding in the Tax Court for a redetermination of a deficiency, the Tax Court shall also have jurisdiction to determine the portion (if any) of such deficiency which is a substantial underpayment attributable to tax motivated transactions.

Emphasis added.

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26 U.S.C. § 6221(c), as applicable to the subject matter of this Petition, was repealed by the Revenue Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106, which enacted the accuracy related penalty in § 6662.

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26 U.S.C. § 6653(a), as amended and effective for tax year 1981. Section 6653(a) was repealed by the Revenue Reduction Act of 1989, P.L. 101-239, 103 Stat. 2106.

SEC. 6653 FAILURE TO PAY TAX.

(a) Negligence or intentional disregard of rules and regulations with respect to income, gift or windfall profits taxes.

(1) In general. In any part of any underpayment (as defined in subsection (c)(1) of any tax imposed by subtitle A, by chapter 12 of subtitle B, or by chapter 45 (relating to windfall profit tax)) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) additional amount for portion attributable to negligence, etc. There shall be added to the tax (in addition to the

amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601

(A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and

(B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax.

CERTIFICATE OF SERVICE

This is to certify that

(i) three copies of the foregoing Petition for Writ of Certiorari were mailed by certified mail, return receipt requested, on June 25, 1996, to:

Solicitor General of the United States,
Department of Justice, Room 5614
10th Street and Constitution Ave., N. W.
Washington, D. C. 20530

(ii) one copy of the foregoing Petition for Writ of Certiori was mailed by certified mail, return receipt requested, on June 25, 1996, to Counsel for the Internal Revenue Service:

Mr. Gary R. Allen
Department of Justice, Tax Division
P. O. Box 502
Washington D. C. 20044

and,

(iii) three copies of the foregoing Petition for Writ of Certiorari were mailed by certified mail, return receipt requested, on June 25, 1996, to:

Commissioner of Internal Revenue
Washington, D. C. 20224

Date: 6/25/96

Thomas E. Redding